

Internal Revenue Service
memorandum

CC:TL-N-4553-89

TS/LJBYUN

date: JUN 13 1989

to: District Counsel, San Francisco W:SF
Attn: Paul J. Krug

from: Acting Senior Technician Reviewer
Tax Shelter Branch CC:TL:TS

subject: [REDACTED]

This is in response to your request for tax litigation advice dated March 8, 1989, regarding a Scar issue in the above mentioned cases.

ISSUE

Are the statutory notices of deficiency in these cases valid under Scar v. Commissioner, 814 F.2d 1363 (9th Cir. 1987)?

CONCLUSION

In the case of [REDACTED], we recommend that the case be defended even though the transcript of account contained incorrect information since the Service did consider information relating to the taxpayers and followed the right procedure in computing the deficiency.

In the case of [REDACTED], we recommend that the case be defended since the errors committed by the Service were not attributable to an incorrect transcript of account. While mistakes were made, we believe a "determination" of the tax liability was made since the Service did examine the transcript of account and the K-1 and proper procedures were followed in computing the deficiency.

FACTS

These two cases are part of the [REDACTED] tax shelter project. Neither case has been set for trial and settlement negotiations are proceeding in both cases. Counsel for petitioners has made settlement offers in both cases. The cases are appealable to the Sixth Circuit.

[REDACTED]:

On their [REDACTED] joint income tax return, the [REDACTED] reported as total wages the sum of \$[REDACTED]. The W-2 for [REDACTED], however, showed his total wages to be \$[REDACTED]. To explain the discrepancy, the [REDACTED] attached an explanation to their [REDACTED]

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income tax return stating that the W-2 incorrectly included short term capital gains in the amount of \$[REDACTED]. Nevertheless, the Service Center entered \$[REDACTED] as wages in the computer and assessed additional taxes. The error was discovered in a subsequent examination and the additional taxes were abated on [REDACTED].

In [REDACTED], the [REDACTED] income tax return was again examined in connection with losses claimed in the amount of \$[REDACTED] arising from [REDACTED].^{1/} These losses were disallowed by the examiner. The [REDACTED] return was not available to the examiner and it did not appear that it would be available before the period of limitations expired.^{2/} Therefore, the deficiency was computed based on the transcript of account.

The transcript of account, however, still showed wages of \$[REDACTED], taxable income of \$[REDACTED] and tax of \$[REDACTED]. The transcript had not been corrected to reflect the [REDACTED] adjustment. Consequently, in computing the deficiency attributable to the disallowed losses, the \$[REDACTED] of disallowed losses were added to a taxable income of \$[REDACTED] (rather than \$[REDACTED]) which resulted in an erroneous "corrected taxable income" of \$[REDACTED] and erroneous "corrected tax" of \$[REDACTED]. The tax shown of \$[REDACTED] was subtracted from \$[REDACTED] resulting in a purported deficiency of \$[REDACTED].

The deficiency notice which was issued to the [REDACTED] on [REDACTED], did not contain the smoking gun language of Scar ("in order to protect the government's interest and since your original income tax return is unavailable at this time, the income tax is being assessed at the maximum rate").

[REDACTED]:

A statutory notice of deficiency was issued to the [REDACTED] on [REDACTED], for the tax year [REDACTED]. The notice specified a deficiency of \$[REDACTED] based on the following adjustments: (1) disallowance of losses with respect to [REDACTED] in the sum of \$[REDACTED] and (2) disallowance of excess intangible drilling costs in the sum of \$[REDACTED]. Also, in the explanatory portion of the notice, a tax credit of \$[REDACTED] was

1/ The Schedule K-1 shows that the [REDACTED] share of the ordinary loss from [REDACTED] was \$[REDACTED]. This loss was claimed on the [REDACTED] return.

2/ The [REDACTED] refused to consent to an extension of the period of limitations.

disallowed. The adjustments were made based only on the transcript of account and the Schedule K-1 for [REDACTED]. Despite the examiner's attempts, the examiner was not able to secure the income tax return before the period of limitations expired.

For the year [REDACTED], [REDACTED] reported \$[REDACTED] of ordinary loss (which includes \$[REDACTED] of intangible drilling costs).^{3/} The sum of \$[REDACTED] is also listed as a tax preference item on the Schedule K (as excess intangible drilling costs). The [REDACTED] K-1 from [REDACTED] showed ordinary loss of \$[REDACTED] and intangible drilling costs in the amount of \$[REDACTED] as a tax preference item. These figures represent their [REDACTED] % share of the partnership loss.

The transcript of account showed AGI of \$[REDACTED], taxable income of \$[REDACTED] and total tax paid of \$[REDACTED]. These figures are confirmed by the return.

In computing the deficiency based on the K-1 and the transcript of account, the tax shown on the return (\$[REDACTED]) was increased by the disallowed amount totalling \$[REDACTED] (\$[REDACTED] + \$[REDACTED]). This resulted in a "corrected taxable income" of \$[REDACTED] and "corrected tax" of \$[REDACTED]. The tax shown of \$[REDACTED] was subtracted from \$[REDACTED] resulting in a deficiency of \$[REDACTED].

As you point out, in reviewing the [REDACTED] income tax return, it is unclear why a tax credit of \$[REDACTED] was disallowed when such credit was neither claimed by the [REDACTED] nor reflected on the transcript of account.^{5/} Also, it is unclear why \$[REDACTED] was disallowed when the [REDACTED] did not claim an additional \$[REDACTED] deduction for intangible drilling costs. As noted above, the \$[REDACTED] of loss disallowed by the Service already included \$[REDACTED] of the intangible drilling costs.^{6/}

3/ \$[REDACTED] is listed as "Other deductions" in line 24 of Form 1065.

4/ The \$[REDACTED] figure is composed of \$[REDACTED] ("Est Tax Base" according to the transcript) and \$[REDACTED] (tax paid per notation to transcript). The taxpayers' return does show a balance due of \$[REDACTED] for [REDACTED].

5/ We note that the asserted deficiency of \$[REDACTED] does not actually include \$[REDACTED] of disallowed credit although such credit is said to be disallowed.

6/ You note that \$[REDACTED] should have been treated as a tax preference item on the [REDACTED] return but that it was not. However, on Form 4625 (Computation of Minimum Tax - Individuals)

The deficiency notice issued to the [REDACTED] also did not contain the smoking gun language of Scar.

DISCUSSION

The Ninth Circuit Court of Appeals held in Scar v. Commissioner, 814 F.2d 1363 (9th Cir. 1987), revq. 81 T.C. 855 (1983), that the deficiency notice issued by the Service was invalid since the Service had not made a "determination" of the taxpayers' correct tax liability. In coming to this conclusion, the Ninth Circuit stated that the "determination" requirement of section 6212(a) has "substantive content." According to the Ninth Circuit, a "determination" implies that the taxpayer's return has been examined where one has been filed. In other words the "Commissioner must consider information that relates to a particular taxpayer before it can be said that the Commissioner has 'determined' a 'deficiency' in respect to that taxpayer." Id. at 1368.

In Scar, the Service did not have the taxpayers' return at the time the deficiency notice was being prepared. In addition, the wrong tax shelter was referred to in the notice and the deficiency was backed into by simply multiplying the adjustment by the maximum rate. Moreover, the deficiency notice specifically admitted that the return had not been examined and that the maximum rate was being applied (i.e., the smoking gun language was used). Based on these facts, the Ninth Circuit came to the following conclusion:

Because the Commissioner's purported notice of deficiency revealed on its face that no determination of tax deficiency had been made in respect to the Scars for the 1978 tax year, it did not meet the requirements of section 6212(a). Scar v. Commissioner, 814 F.2d at 1370.

The Service does not agree with the Ninth Circuit's "substantive content" standard for testing the validity of the deficiency notices under section 6212(a). Rather, we continue to agree with the majority of the Tax Court and the dissenting

which is attached to the [REDACTED] Form 1040, the [REDACTED] reflected intangible drilling costs as a tax preference item in the amount of \$[REDACTED]. There is no explanation of what this figure is composed of. Consequently, we are unable to determine whether the [REDACTED] did or did not treat \$[REDACTED] as a tax preference item.

opinion in Scar that the deficiency notice is nothing more than a "ticket" to the Tax Court. Accordingly, it is our position that it is sufficient if the deficiency notice meets the following limited requirements announced in Olsen v. Helvering, 88 F.2d 650 (2d. Cir. 1937):

- (1) taxpayer's name is specified,
- (2) the year and amount is specified, and
- (3) it reflects an unequivocal intent to assess.^{7/}

However, as a result of the uncertainty of the scope of Scar, the Service wants to restrict the impact of the decision to the facts in that case. Therefore, the Service will not relitigate the "determination issue" on facts not materially different from Scar.

The [REDACTED] case is clearly distinguishable from the facts of Scar. In [REDACTED], the deficiency notice contained the right shelter and the right amount and did not contain the smoking gun language. Moreover, the deficiency was not backed into; the Service properly computed the deficiency by adjusting the taxable income to reflect the disallowed losses and deducting the tax shown. Unfortunately, the transcript contained incorrect information. Thus, while the procedure was correct, the information was not.

It is the Service position that we do not need to have the original return to make a determination. Instead, we can rely on taxpayer return information found in the transcript of account, as well as relevant K-1's. Such a position, as you point out, depends on the accuracy of the transcript of account. However, while recognizing the hazards presented by the incorrect transcript of account, we believe this case should be defended since the facts suggest that a "determination" was nevertheless made in this case. Although the inaccuracy in the transcript lead to the assertion of a bigger deficiency than actually

^{7/} We note that even the 9th Circuit acknowledges that in the "usual case" (i.e., where the notice is not patently incorrect as in Scar), the sending of the notice of deficiency presumes a determination. Scar v. Commissioner, 814 F.2d at 1369 n.9. Moreover, the Court expressly agrees with the Tax Court that no particular form is required for a valid deficiency notice and that an explanation need not be furnished by the Commissioner with respect to the determination of the deficiency. Id. at 1367. With respect to this last point, we note that in Campbell v. Commissioner, 90 T.C. 110 (1988), the Tax Court upheld a deficiency notice which contained computational sheets relating to another taxpayer.

existed, it is clear that the right procedure was followed in computing the deficiency and that the Service did consider information relating to the taxpayers (as reflected by the right shelter and the right adjustment). Of course, had the actual return been reviewed, the error may not have occurred. However, we do not believe the error committed here precludes a finding of a "determination". Moreover, the lack of the smoking gun language such as was used in the notice in Scar means that the notice does not suggest on its face that no determination was made.^{8/} Therefore, we recommend that the deficiency notice in this case be defended.

We also do not recommend acceptance of the settlement offer in the [REDACTED] case. Like [REDACTED], the [REDACTED] case is clearly distinguishable from the facts of Scar. Here, too, the deficiency notice contained the right shelter and the right amount and did not contain the smoking gun language. Furthermore, the deficiency was not backed into in that the examiner properly adjusted the taxable income and deducted the tax shown in computing the deficiency. But unlike [REDACTED], the transcript of account contained correct information. Therefore, in the [REDACTED] case, we believe the fact that a transcript of account was used in computing the deficiency should be defended as a means of determining a deficiency.

You note that in this case the deficiency notice contains adjustments that do not relate to either the transcript or the return. Therefore, you are concerned that the court could find that the transcripts are inherently unreliable. While we share in this concern, we believe this case should be defended since the errors (i.e., disallowing credits and losses that were never claimed) are not attributable to the transcript. The transcript contained the same information as the return. Therefore, the same mistakes might have been made by the examiner even if the return had been available. While mistakes were made, we do not

8/ Recently, the Ninth Circuit in Clapp v. Commissioner, No. 88-7083, slip op. at 5517 (9th Cir. May 24, 1989), clarified that only where the deficiency notice is incorrect on its face is the Commissioner required to prove that a determination was made. The Court stated: "Furthermore, as the Tax Court has since pointed out, Scar did not even require any affirmative showing by the Commissioner that a determination set forth in an alleged notice of deficiency was made on the basis of the taxpayers' return. Only where the notice of deficiency reveals on its face that the Commissioner failed to make a determination is the Commissioner required to prove that he did not in fact make a determination. Campbell v. Commissioner, 90 T.C. 110 (1988). Here, nothing on the face of the notice reveals that the Commissioner failed to make a determination." (Emphasis added).

believe they were the type of mistakes prohibited by Scar. Rather, the facts indicate that a "determination" was made (albeit an erroneous determination) since the Service did examine the transcript of account and the K-1 and followed the correct procedure in computing the deficiency. Furthermore, even the Ninth Circuit in Scar acknowledged that courts should avoid oversight of the Commissioner's internal operations and the adequacy of procedures unless the notice itself reveals that no determination was made. The notice of deficiency in this case contains no such revelation. Scar v. Commissioner, 814 F.2d at 1368. Therefore, we recommend that the incorrect adjustments be conceded in an amended answer and that you proceed with the case on the shelter disallowance.

We are returning herewith the two legal files for the above cases. If you should have any questions, please contact Lisa Byun on FTS 566-3289.


CURTIS G. WILSON

Attachments:
As stated.